



220.0325

STATE BOARD OF EQUALIZATION

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 324-6593

WILLIAM M. BENNETT
First District, Kentfield

CONWAY H. COLLI
Second District, Los Angeles

ERNEST J. DRONENBURG, JR.
Third District, San Diego

PAUL CARPENTER
Fourth District, Los Angeles

GRAY DAVIS
Controller, Sacramento

CINDY RAMBO
Executive Director

May 10, 1989

Dear

This is sent in response to your letter dated March 8, 1989, to Richard Ochsner, Assistant Chief Counsel, wherein you request an opinion regarding the change in ownership consequences of the sale of the Buenaventura Plaza Shopping Center (the "center") in 1987. At the time of sale, a portion of such center was subject to a lease to the J. C. Penney Company ("Penney's"). The owner of the center and Penney's have asserted that such lease had a remaining term of 35 years or more at the date of sale. If true, this would render such leased portion of the center exempt from any change in ownership consequences which would otherwise have resulted from the sale of the center, pursuant to Rule 462(F)(2)(B) of the Property Tax Rules set forth in Title 18 of the California Code of Regulations.

To assist in our determination, you have provided us with a copy of that certain document entitled Amendment to and Restatement of Lease Agreement dated April 18, 1983 (the "modified lease"). We have independently obtained from the center owner a copy of the original lease dated November 14, 1962 (the "original lease"). I have enclosed a copy of such original lease for your records.

Facts

The facts as set forth both in your letter and in the leases are as follows:

1. On November 14, 1962, a limited partnership (sometimes referred to as "owner" or "lessor"), and Penney's (sometimes referred to as "lessee") entered into the original lease. The terms of such lease can be summarized as follows:

May 10, 1989

- a. Premises: (i) Parts of lots P and Q, upon which lessor was to construct a one-story building with a ground floor area of 102,400 square feet, with a 20,000 square foot basement, which building was to be used as lessee's main store; and (ii) an additional 9,000 square foot lot, upon which lessor was to construct another one-story building with a ground floor area not exceeding 8,000 square feet, for use as a tire and auto service shop.
- b. Term: An initial term of 25 years plus two successive options to extend for additional periods of 10 years each.
- c. Rent: (i) During the initial 25-year term, the annual rental was to be equal to 12 times a uniform monthly payment composed of that principal and interest necessary to fully amortize the cost of the construction of the two buildings over a 25-year period, together with interest thereon at an agreed rate. (ii) For the 26th year and continuing throughout the optional extension periods, the initial annual rental was to be reduced by 50 percent. (iii) Percentage rental of .5 percent for sales up to \$19,000,000 and .25 percent for sales over such amount.

2. On April 18, 1983, lessor and lessee executed the modified lease. Other than in a few provisions, no attempt was made to preserve the form or wording of the original document. The modified lease contains many additions and changes to the original terms, including additions and changes of both major and minor significance, as is evident from a comparison of the two documents. Such modified lease states the following at page 1:

Effective as of the date of recording of a short form of this Restated Lease, the Original Lease is hereby amended and restated in its entirety as hereinafter set forth, and as so amended and restated shall remain in full force and effect, and Landlord and Tenant agree that in the case of each and every conflict between the provisions of said Original Lease and this Lease, the provisions of this Lease shall prevail and control. It is further acknowledged and agreed that as a result of the realignment and reconfiguration of the boundaries of the Demised Premises, as provided in this Lease, the covenants of

May 10, 1989

Landlord and Tenant which were created by the Original Lease, that burdened or affected the Demised Premises are, as to each of Landlord and Tenant, released and terminated, to the extent such easements and covenants bound and related to any portion of the Demised Premises which, as of the effective date of such realignment and reconfiguration, has been released from and ceased to be a part of the Demised Premises. From and after the effective date of this Lease the covenants and agreements of the Landlord and Tenant shall relate to the Demised Premises and the Entire Premises as such parcels are described in Exhibits A and B and shown on Exhibit C. This Lease shall not be effective until it has been executed and acknowledged by Landlord and Penney's, and until a short form thereof has been recorded in the Office of the Recorder of Ventura County, California.

The terms of the modified lease can be summarized as follows:

- a. Premises: Includes the building with the 102,400 square foot ground floor area, plus irrevocable easements for: (i) non-exclusive use of the common areas (including the enclosed mall), plus utility systems, (ii) exclusive use of certain canopies, overhangs, ramps, etc., (iii) use of certain corridors and stairs and (iv) use of certain rights-of-way. The tire shop building referenced in the original lease is no longer being rented to Penney's and, therefore, does not appear in the new description of the demised premises.
- b. Term: The term is described as commencing on November 10, 1965, and continuing for 25 years thereafter, to November 30, 1990. The options to extend are as follows: (i) Three successive options, the first two of which are for additional periods of five years each, and the third of which is for a separate additional period of ten years; and (ii) lessee is given the further option to extend the lease for up to an additional 20 years, subject to lessee agreeing to construct a second-floor area on lessee's store building (the "performance option").
- c. Rent: (i) The rental from the date of the lease to November 30, 1990, is set at \$173,451.24 per year.

May 10, 1989

(ii) The rental during any extension period is set at \$86,725.62 per year. (iii) The percentage rental amounts are the same, but the other percentage rental provisions are substantially different from those set forth in the original lease.

3. As indicated above, the owner sold the center in 1987, causing your office to undertake the contested reappraisal.

4. You have indicated your opinion that the economics of the center make any expansion unlikely. Therefore, you feel that Penney's does not have any intention of exercising the 20-year performance option set forth in the modified lease.

You have requested our opinion of the change in ownership consequences of the above-described transactions.

Law and Analysis

Pursuant to section 61 of the Revenue and Taxation Code (all section references contained herein are to the Revenue and Taxation Code unless otherwise specified):

Except as otherwise provided in Section 62, change in ownership . . . includes, but is not limited to:

* * *

(c)(1) The creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options), the termination of a leasehold interest in taxable real property which had an original term of 35 years or more (including renewal options), and any transfer of a leasehold interest having a remaining term of 35 years or more (including renewal options); or (2) any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of less than 35 years.

Only that portion of a property subject to such lease or transfer shall be considered to have undergone a change of ownership.

* * *

May 10, 1989

Said section 61(c) is based upon a recognition that a long-term lease can serve as the means of conveying the equivalent of a fee interest to the lessee. It also reflects the need to identify one primary owner in order to simplify the assessment process. With these facts in mind, the Legislature has essentially provided that the holder of a leasehold interest with a term of 35 years or more is to be treated like the owner of the property for change in ownership purposes. Ehrman & Flavin, Taxing California Property (Callaghan, 1988), p. 42.

In the instant matter, the original lease was executed on November 14, 1962. The "original term" of such lease, including renewal options, was 45 years.

Subsequently, on April 18, 1983, the modified lease was executed between lessor and lessee. As set forth above, and as is evident from an examination of the documents, the modified lease made many additions and changes to the original terms. For our purposes, the most significant changes, were: (1) the termination of the leasehold as to the tire shop building and (2) the addition of the 20-year performance option.

Clearly, on April 18, 1983, the original lease was terminated as to the tire shop building. It is also clear, however, that the provisions of the so-called Amendment to and Restatement of Lease Agreement, taken as a whole, are materially different from those set forth in the original lease. Due to the magnitude of these differences, it can be argued that the modified lease should be considered as being, for our purposes, a new lease between the parties, one which effectively terminated the original leasehold.

Assuming that such argument is correct, the execution of such modified lease can be seen as ". . . the termination of a leasehold interest in taxable real property which had an original term of 35 years or more (including renewal options) . . . ," within the meaning of said section 61(c). Subject to the above, our conclusion would be that a change in ownership occurred on April 18, 1983, not just of the tire shop, but of all portions of the center subject to such Penney's lease.

Concurrent with such arguable termination of the entire original lease, the term of the new, modified lease commenced. As indicated above, the term of such modified lease was to continue from April 18, 1983, until November 30, 1990, with 20 years of optional extension periods following. Adding these extension options to the initial term results in an approximate 27-year term, short of the "more than 35 years" threshold provided in section 61. However, if the 20-year performance

May 10, 1989

option is considered as a "renewal option" and is therefore added to the above, the threshold is exceeded. Under this analysis, the execution of such modified lease would in any event be deemed to be the creation of a leasehold interest in taxable real property for a term of 35 years or more under section 61(c). Therefore, this approach also results in a change in ownership for the entire lease premises in 1983. The tire shop, due to the termination of its lease, and the main store building, on account of the creation of a leasehold interest with a remaining term of 47 years, including renewal options.

With regard to the 1987 sale, the question you have posed is whether or not such 20-year performance option, in fact, must be so included as a "renewal option" in calculating the lease term.

In examining such provision, it appears that the terms and conditions thereof are sufficiently definite to constitute an option which is binding on the lessor. Furthermore, there is no indication that the provision was entered into in other than an "arms length" negotiation. The fact that the consideration for the extension term is in the form of the lessee's partial subsidization of major construction work to be performed on the lessor's building would not necessarily serve to disqualify the option.

The modified lease was not drafted in such a fashion that the 20-year performance option only comes into being after the tenant undertakes or completes the construction work. If such were the case, the argument that such provision did not, for our purposes, constitute a true "renewal option" would be stronger. However, the express terms of the lease provide that the tenant simultaneously elects to exercise the option and construct the improvements.

You state your opinion that the economics of the center make it unlikely that any expansion will be undertaken so as to fulfill the requirements of the performance option. However, the provisions of section 61(c) do not indicate that an option must be deemed likely to be exercised in order for the same to qualify as a "renewal option" under the terms thereof.

Pursuant to the above, it appears that the execution of such new, modified lease on April 18, 1983, should be held to constitute the creation of a new leasehold interest for a term of 35 years or more (including renewal options) within the meaning of section 61(c). The designation of the demised premises in such lease sets forth the portion of the center subject thereto.

May 10, 1989


Under this approach, when the property sold in 1987, there were still approximately 43 years potentially left to run on said lease. Pursuant to subparagraph (g) of section 62, change in ownership does not include any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of 35 years or more. Rule 462(F)(2)(B), as cited by you, is to the same effect.

Subject to the above analysis, and pursuant to said referenced section 62(g) and rule 462(F)(2)(B), the sale of the center in 1987 would not constitute a change in ownership as to those portions thereof which were subject to the modified Penney's lease at that time.

If, contrary to the above, the 20-year performance option was not considered to be a "renewal option," then, in such case, the execution of the modified lease in 1983 would not be held to be a change in ownership, but the subsequent 1987 sale would constitute such a change, resulting in a reappraisal in such later year. However, as indicated above, we see no reason why the performance option should not be considered to be a qualifying "renewal option" for purposes of section 61.

Please call me should you have any further comments or questions with regard to this matter.

Yours very truly,


Robert W. Lambert
Tax Counsel

RWL:wak
2386H

Enclosure

cc: Mr. John Hagerty
Mr. Robert Gustafson
Mr. Verne Walton